IMPACT OF FINANCIAL MARKET LIBERALISATION ON THE MANAGEMENT OF 
MACROECONOMIC POLICIES AND ON ECONOMIC PERFORMANCE

Report on a meeting of trade union experts 
held under the OECD Labour/Management Programme

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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IMPACT OF FINANCIAL MARKET LIBERALISATION ON THE MANAGEMENT OF MACROECONOMIC POLICIES AND ON ECONOMIC PERFORMANCE

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(Paris, 17-18 June 1993)

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Foreword

Under the OECD Labour/Management Programme for 1993, a meeting of trade union experts on the "Impact of financial market liberalisation on the management of macroeconomic policies and on economic performance" was held in Paris on 17 and 18 June 1993. The meeting was prepared in collaboration with the Trade Union Advisory Committee to the OECD (TUAC).

Below is an overall report of the discussions of the meeting of experts, prepared by Mr. Kazuo Ueda who was designated as General Rapporteur for this activity.

A list of the participants in the meeting is given in the Annex.

THE OPINIONS EXPRESSED AND ARGUMENTS EMPLOYED IN THIS REPORT ARE THE RESPONSIBILITY OF THE AUTHOR AND DO NOT NECESSARILY REPRESENT THOSE OF THE OECD.
I. INTRODUCTION

A significant degree of financial liberalisation took place in many OECD countries over the last few decades. In some countries the pace of liberalisation speeded up especially in the 1980s.

Financial liberalisation brings about more efficient allocation of credit through more flexible participation by lenders and borrowers of funds on financial markets and the resulting determination of assets prices based more on economic fundamentals.

Some contend, however, that the efficiency gain from financial liberalisation was not as large as expected. Rather, financial liberalisation led to increased speculative activities in financial markets and to occasional deviations of assets prices from the levels warranted by fundamentals. In such a case, the argument goes, the allocation of resources may have become more inefficient.

The discussion at the meeting of trade union experts also reflected such differences in the evaluation of the effects of financial liberalisation on the economy. Some experts were very much worried about adverse employment consequences of financial liberalisation. Others, however, considered that such effects, if there were any, would be minor and that the benefits of liberalisation, much larger. Since the benefits of liberalisation have been well documented, the discussion at the meeting focused more on the costs of liberalisation. This does not mean that participants shared the view that the costs outweighed the benefits. Rather, the discussion at the meeting centred on finding ways to minimise the costs of liberalisation so that the benefits could be maximised. It would be fair to say, however, that significant differences in views on the effects of liberalisation still remained even after the completion of the meeting.

Reflecting such diversity of the views expressed at the meeting, this paper first surveys some useful evidence on the process of financial liberalisation and the macroeconomic effects on policy and economic performance thereof, paying particular attention to both benefits and costs of liberalisation. It then summarises the discussions of the meeting of experts on some of the key unresolved questions concerning the effects of financial liberalisation.

The paper divides the discussion of the effects of financial liberalisation into two parts: one, the effects on domestic financial markets and the other, those on the foreign exchange market. This division is not essential because the exchange rate is an asset price that is determined basically in the same manner as interest rates and stock prices are. The discussion of the effects of exchange rate changes on macroeconomic policy, however, involves topics such as the choice of the optimal exchange rate system and international policy co-ordination, which are more appropriately discussed separately from domestic issues.
II. STANDARD ARGUMENTS ABOUT FINANCIAL LIBERALISATION

Before going into the discussion at the meeting, it would be useful to look briefly at the process of financial liberalisation that took place during the last decade and summarise standard arguments about the costs and benefits of liberalisation.

The process of liberalisation

Table 1 (from Blundell-Wignall, Browne & Manasse (1990)) conveniently summarises the process of financial liberalisation in some major OECD countries. Credit and interest rate ceilings were abolished in many countries. Restrictions on international capital movements were relaxed. Regulations on who can participate in what markets and those on the nature of financial products ("powers" regulation) were also relaxed.

The extent to which the liberalisation has proceeded varies from country to country. On "rate/quantity" regulations, Germany deregulated at the earliest stage. The US, Canada and the UK deregulated relatively early. Japan took important steps in the 1980s, while France and Italy moved slowly. The similar ranking of countries applies to "powers" regulations as well, except that Germany lags far behind the others on this score. For example, competition among German banks is very much limited. Short-term money markets are underdeveloped in Germany. (Blundell-Wignall & Browne (1991), p. 5.)

In any case, deregulations have allowed increased and more flexible access to credit for businesses and consumers. They have brought about increased returns and opportunities for risk diversification to investors as well as increased competition among financial intermediaries.

The macroeconomic effects of financial liberalisation

Major beneficiaries of deregulation in financial markets are users of the markets. Households and firms have access to a greater number of financial services and in a more flexible manner than without deregulation. They can diversify risks more easily, implying that assets price volatility becomes less of a problem. They can borrow and lend larger amounts, that is, they will be less liquidity constrained. For households, consumption responds more to permanent income than to current income. For firms, investment is determined more by the rate of profit and the interest rate than by the availability of credit.

Prices in financial markets become more flexible. Hence, financial markets become more efficient. That is, prices reflect information concerning underlying fundamentals more swiftly and accurately. This will result in more efficient allocation of credit.

Monetary policy will work more by changing assets prices than through monetary aggregates. But the relationship between monetary policy and assets prices would become more complicated because of increased role of expectations in the determination of assets prices. Blundell-Wignall & Browne offer evidence in support of some of these propositions (Blundell-Wignall & Browne, pp. 8-12.)

The foregoing discussion suggests that there could be costs of financial liberalisation as well as benefits.
Decreased importance of liquidity constraints could be a problem if borrowers and/or lenders were not behaving rationally. Deregulation may lead to potentially unsustainable accumulation of private sector debt. This problem could become more serious if deregulation and the resulting increase in competition between bank lending and bonds/equity financing led banks to increase lending without sufficient credit analysis. In such a case, deregulation may create a more fragile financial system.

On an international scale, increased capital movements imply that nations can borrow and lend to a larger extent. A result of this would be larger current account imbalances. A similar problem as discussed above could emerge from large international payment imbalances.

At the root of the benefits of financial liberalisation is the determination of assets prices more in line with economic fundamentals. Consequently, costs would arise if deregulation increased the possibility of assets price bubbles. Short-term bubbles can be hedged away thanks to the development of derivatives markets -- one of the benefits of deregulation. A medium to long-term deviation of assets prices from fundamentals would, however, create a misallocation of resources. The sharp rise in stock prices in the late 1980s may have resulted in excess investment in plant and equipment in some countries, especially in Japan. The overvalued dollar in the early to mid 1980s exerted serious negative impacts on US traded goods industries.

Even short-term volatility in assets prices can create welfare losses. Some have expressed concern for the possibility of "short-termism", i.e. a general shortening of time horizons in investor behaviour as a result of increased price volatility in assets markets. (However, a simple regression analysis carried out by Blundell-Wignall & Browne, Table 9 of their paper, fails to uncover such an effect for the stock market.)

III. DELEGATES’ VIEWS ON THE EFFECTS OF FINANCIAL LIBERALISATION

At the meeting of trade union experts, views were sharply divided on whether or not financial liberalisation would bring about increased well-being of economic agents involved. Though many agreed that the merits of financial liberalisation as summarised in the last section were important, some expressed concern over possible demerits of financial liberalisation.

Among the costs of financial liberalisation, attention focused on (i) large medium-term swings in assets prices as observed in the late 1980s and early 1990s and their adverse effects on the real economy; and (ii) the effects of increased international capital mobility on the income distribution between owners of labour and capital. This section takes up the first of these two concerns, while the next section addresses the second, i.e. international aspects of the problem.

One major common feature of assets markets of many countries over the last decade was the increased volatility of assets prices, especially stock and real estate prices. Table 2 (taken from Blundell-Wignall & Browne) shows this for stock prices and exchange rates. The volatility of exchange rates increased in the 1980s for all the four rates shown in the table (the topic for the next section). For stock prices, the volatility went up in the late 1980s relative to the 1970s with the exception of the UK and Canada. No systematic evidence of increased bonds price volatility is observed.
In addition to the volatility of short-term returns, large medium-term swings in stock and real estate prices have been a concern for both market participants and policy makers. A typical example is Japan, where stock prices rose by about 300% in the second half of the 1980s and fell by over 60% between 1990 and 1992. Real estate prices have followed a similar trend. Similar movements in stock and, especially, real estate prices were observed in many OECD economies.

Deregulation and medium-term swings in assets prices

Delegates were particularly concerned about medium-term swings in assets prices and their implications for the real economy and for the appropriate regulatory framework for the financial sector. At the heart of the sharp swings in assets prices during the last few years has been the behaviour of the banking sector. In the late 1980s banks expanded their loans to equity and land related investment in a deregulated environment, but are now suffering from large accumulation of non-performing loans and are cutting off on new loans.

An obvious question is what was behind the behaviour of banks. One major candidate for the cause of the dramatic increase in bank loans and the resulting sharp rise in assets prices in the late 1980s is the loose monetary policy adopted in many OECD countries. Many central banks turned to monetary tightening toward the end of the 1980s or in the early 1990s, which may explain the decline in assets prices that followed. This still leaves the question of why many central banks adopted loose monetary policy in the late 1980s. One possible explanation would be the increased international monetary policy co-ordination at the time of US monetary expansion.

A different explanation of the assets price volatility, one that was emphasised at the meeting, stresses the effects of financial deregulation on bank behaviour. Relaxation of "power" regulations led to increased competition between banks and other financial intermediaries. Banks may have been forced to increase lending aggressively at the expense of the decline in the quality of credit analysis. Such behaviour may have resulted in increased real estate and equity investment related lendings and intensified the rise in assets prices in the 1980s.

Financial institutions in some countries were thrown into a deregulated environment for the first time in many years. Some delegates argued that the lack of expertise to cope with the deregulated environment was the major factor behind the financial instability in these countries.

Such a perspective may be useful for understanding differences in the severity of assets price inflation and deflation among OECD economies. The price volatility was higher for Japan and some Scandinavian countries. These countries went through the process of rapid financial deregulation in the 1980s. Assets price volatility was relatively lower for the US (with the exception of the Black Monday episode) and other European countries.

This perspective seems to apply to the LDC debt problems of the 1980s as well. A significant degree of financial liberalisations took place in the US in the 1970s. In particular, bank loans had to compete with commercial papers. Larger firms increasingly relied on commercial papers for raising short-term funds. Hence, banks found it easier to expand risky loans to non-oil developing countries, rather than to find domestic customers.
On the other hand, others argued that financial institutions, irrespective of the degree of the accumulation of expertise, always had the tendency to behave irrationally in a deregulated environment.

**Short-term volatility of assets prices**

Another, but related, explanation of the large swings in the assets prices would be to view them as a formation of bubbles and their collapses. This view would be more important for increased short-run volatility of assets prices because medium-term swings in monetary policy cannot be the explanation of it. Unfortunately, it has been very difficult to empirically prove or disprove the existence of a bubble even for professional economists. Nevertheless, the work of Shiller and others points to the possibility that bubbles do show up in many assets markets (Shiller (1989)).

Many participants wondered if financial deregulation and the deviation of assets prices from fundamentals were not related. One view of speculation holds that it increases assets price volatility. More specifically, empirical researches on the nature of investors’ expectations have revealed that they tend to be destabilising, i.e. a price rise creating an expectation of a further price rise, at short horizons and stabilising at longer horizons (Frankel & Froot, (1986)). Deregulation may have, in certain cases, encouraged short-term speculation, thus increasing the possibility of creating bubbles.

One adverse consequence of increased short-term speculation in financial markets may be that the time horizon of corporate managers may also have shortened. This might have exerted negative impacts on long-term growth prospects of firms, especially on the well-being of workers.

**Credit crunches**

On the macroeconomic front, the severity of current credit crunches attracted the attention of many delegates as a problem that might require policy responses. That is, several large OECD countries have experienced a slowdown in bank lending in recent years. (See Figure 1, taken from O’Brien & Browne). Some delegates attributed this to a change in the behaviour of banks as discussed above. On this interpretation, the collapse of assets prices and more rigorous prudential supervision have forced banks to raise the relative price of loans.

Views differed, however, as to the relative importance of the decline in assets prices, the BIS regulation, and the cyclical weakening of the economies as causes of the slowdown in bank lending. (Some useful references are O’Brien and Browne (1992) and Federal Reserve Bank of New York (1993)). Again, participants did not reach agreement on this point. Financial deregulation may have played a role here, to the extent that the burst of the "bubbles" in the 1980s was a cause of credit crunches.

Borrowers of funds, households and firms, are now also forced to change their behaviour. The indebtedness of the private sector increased in many countries during the 1980s. Again, this may have been a result of financial liberalisation that weakened liquidity constraints. In any case, debtors are obliged to restructure their balance-sheets, adding to the severity of recession in many countries.
Coping with adverse consequences of domestic financial liberalisation

Policy recommendations for coping with adverse consequences of financial liberalisation ranged from taking expansionary macroeconomic policies to offset the deflationary impacts of the collapse of bubbles to outright restriction on the behaviour of financial institutions and investors.

Some participants called for concerted monetary expansion among OECD countries to cope with the current credit crunches. Others thought that this was unnecessary and would create a danger of world-wide inflation. Some others recommended that structural policies such as encouraging securitisation of bad loans be considered. In a similar vein, some advocated increased allocation of SDRs, especially to developing countries. But others commented that its expansionary impact on the world economy would be of limited magnitude.

More broadly, those who thought financial liberalisation was responsible for some of the current problems in the financial sector recommended that the pace of liberalisation be slowed. Others thought that such a view attributes too much of current problems to financial liberalisation and that it fails to adequately understand the benefits of liberalisation.

IV. DELEGATES’ VIEWS ON THE CONSEQUENCES OF INCREASED INTERNATIONAL CAPITAL MOBILITY

Views of the delegates were also divided on the welfare consequences of deregulation of international financial activities, i.e. increased international capital mobility. Some delegates regarded the possible adverse employment consequences in capital exporting countries as most serious.

Theoretically, increased capital mobility will benefit workers in the capital receiving country and owners of capital in the capital exporting country. But it may be somewhat costly to workers in the capital exporting country as domestic capital labour ratio would be lower than without international capital mobility. The cost may take the form of decreased wages in the long run, but of decreased employment opportunities in the short run.

Many participants thought that the adverse employment effect of increased capital mobility in capital exporting countries is a real possibility. Exchange rates in capital exporting countries, however, tend to depreciate and thereby exert favourable effects on employment in traded goods industries. Thus, to the extent that labour can freely move between sectors, the adverse employment effect of free capital mobility may be somewhat mitigated.

Bloom & Brender (1993) show that most of the increase in capital mobility, especially that of foreign direct investment, has taken place between developed industrial countries. (Table 3, from Bloom & Brender.) In this sense, workers in some developed economies may have benefited from increased capital mobility. A typical example of this is the increased tendency in the automobile industry to produce in the country where automobiles are used. This has certainly had a favourable effect on employment in automobile importing countries.
The volatility of exchange rates and the optimal exchange rate system were also a topic of discussion at the meeting. Some participants saw important connections between financial liberalisation and increased exchange rate volatility. Table 2 has already documented the increased volatility of exchange rates in the 1980s relative to the 1970s. Explaining the increased volatility, however, has been a major challenge to international finance economists. Theoretically speaking, increased capital movements imply larger effects of interest rate differentials on exchange rates. Interest rate differentials alone, however, do not seem to suffice to explain increased exchange rate movements. Have there been bubbles in exchange rate movements? Again, this is an unresolved question. Among others, Krugman (1985) has suggested that there have been.

Does exchange rate volatility matter? Blundell-Wignall & Browne offer evidence that the effect of short-run volatility of exchange rates on trade flows has been negligible. Many believe, however, that medium-term misalignments have been associated with large welfare losses, the effect of the strong dollar on US traded goods industries during the early to mid 1980s being a good example (assuming that it was a bubble).

At the meeting, however, the discussion on exchange rate volatility mostly centred on current European problems. Some participants considered the speculative attack on the ERM as observed within the last year or so as harmful. Equally serious had been the loss of monetary autonomy imposed by the ERM in countries where monetary expansion was required because of stagnant employment situations. This view was shared by many, if not all, participants.

In addition, participants pointed out the possibility that some countries may have kept their exchange rates artificially low in order to bring about increased demand for their goods and services.

Coping with increased international capital mobility

What are the ways to minimise the costs of and maximise the benefits of increased international capital mobility? Do we want to place any restrictions, including taxation measures, on international borrowing and lending activities?

Some participants advocated introducing taxation measures to limit the extent of international capital mobility. For example, the Tobin tax, i.e. a proportional tax on the amount of financial transactions, would decrease the incentive for speculation at short horizons and thereby the likelihood of bubbles or misalignments of exchange rates. Counteracting this was the argument that the Tobin tax would not be very effective unless the tax rate was prohibitively high. For example, there is a 1% proportional tax on transactions in the Japanese stock market. But the tax seems to have had a minor effect in preventing a bubble like behaviour of stock prices in the late 1980s. Also, there was a concern about the implementability of the measure for international transactions.

The appropriate degree of exchange rate flexibility was also an important topic for discussion at the meeting. That is, there is a choice of the appropriate exchange rate regime from a fairly wide range of alternatives including: target zones, fixed exchange rates, common currency areas and flexible rates. The pros and cons of the alternative exchange rate systems
have been widely discussed in the literature. The most important perspective would be that fixing of exchange rates creates the benefit of avoiding misalignments and excessive short-run volatility of nominal exchange rates, while raising the problem of less monetary independence as exemplified by delegates’ discussions of the ERM experience. In order to achieve both exchange rate stability and monetary policy autonomy, the benefits of increased international capital mobility will have to be abandoned. At the meeting, on the one hand, some recommended limiting the degree of flexibility of exchange rates as discussed above. On the other, under high international capital mobility, one of the participants observed, adjustable pegs would not be sustainable. Exchange rates either had to be fully flexible, or completely fixed.

V. CONCLUDING REMARKS

There is widespread fear, especially prevalent among non-specialists of finance, that financial deregulation may encourage financial activities at the expense of real economic activities. Such a concern was clearly present among participants of the meeting of trade union experts.

A large part of such fear is based on misunderstanding about the relationship between the monetary and the real sectors of economies. Increased lending by banks to financial activities, for example, will not decrease the amount of goods and services available for use in the real sector. Rather, financial activities are there to find non-financial firms with high rates of return. In this sense, financial liberalisation is beneficial to non-financial firms as well.

In some cases, however, increased financial activities may come at non-negligible costs. First, financial markets may not succeed in finding firms with high real rates of return. Decisions in financial markets are at times dominated by short-term speculations. In such a case, funds will flow into sub-optimal sectors.

Second, even if activities in financial markets are largely rational, they may have income distribution consequences. Financial liberalisation tends to create concentration of wealth in the hands of a small number of people with professional knowledge about financial markets. Delegates at the meeting expressed more serious concern over the effects of financial liberalisation on income distribution between labour and capital. This was apparent when delegates pointed out the negative effects of international capital flows on employment and wages of capital exporting countries.

The benefits of financial liberalisations, however, are too huge to be ignored. The role of international capital mobility, in particular, has increased for achieving efficient allocation of resources in the face of low labour mobility and increased tendency for protectionism on the trade side. Many participants of the meeting pointed out that the tide toward liberalisation should not be reversed. A desirable policy approach to the costs of financial liberalisation would not be to reregulate, but to minimise the ill-effects of excessive short-term speculation while preserving most of the benefits of liberalisation.
References:


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